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to the extent that such reductions are consistent with GAAP; and

(ii) Sales of the assets of the transferred company.

(c) *Valuation example.* The parent holding company of a member bank contributes between 25 and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of \$300,000 and total liabilities of \$100,000. The mortgage company's assets do not include any loans to an affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of this section. The member bank initially must value the transaction at \$100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at \$100,000. If the member bank, however, sells \$15,000 of the transferred assets of the mortgage company or if \$15,000 of the transferred assets amortize, the member bank may value the covered transaction at \$85,000.

(d) *Exemption for step transactions.* A transaction described in paragraph (a) of this section is exempt from the requirements of this regulation (other than the safety and soundness requirement of § 223.13 and the market terms requirement of § 223.51) if:

(1) The member bank acquires the securities issued by the transferred company within one business day (or such longer period, up to three months, as may be permitted by the member bank's appropriate Federal banking agency) after the company becomes an affiliate of the member bank;

(2) The member bank acquires all the securities of the transferred company that were transferred in connection

with the transaction that made the company an affiliate of the member bank;

(3) The business and financial condition (including the asset quality and liabilities) of the transferred company does not materially change from the time the company becomes an affiliate of the member bank and the time the member bank acquires the securities issued by the company; and

(4) At or before the time that the transferred company becomes an affiliate of the member bank, the member bank notifies its appropriate Federal banking agency and the Board of the member bank's intent to acquire the company.

(e) *Example of step transaction.* A bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate Federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of this section, would qualify for the exemption in paragraph (d) of this section.

§ 223.32 What rules apply to financial subsidiaries of a member bank?

(a) *Exemption from the 10 percent limit for covered transactions between a member bank and a single financial subsidiary.* The 10 percent quantitative limit contained in § 223.11 does not apply with respect to covered transactions between a member bank and a financial subsidiary of the member bank. The 20 percent quantitative limit

contained in § 223.12 does apply to such transactions.

(b) *Valuation of purchases of or investments in the securities of a financial subsidiary*—(1) *General rule.* A member bank's purchase of or investment in a security issued by a financial subsidiary of the member bank must be valued at the greater of:

(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the security, reduced to reflect amortization of the security to the extent consistent with GAAP; and

(ii) The carrying value of the security (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the security).

(2) *Carrying value of an investment in a consolidated financial subsidiary.* If a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the member bank's investment in securities issued by the financial subsidiary shall be equal to the carrying value of the securities on parent-only financial statements of the member bank, determined in accordance with GAAP (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the securities).

(3) *Examples of the valuation of purchases of and investments in the securities of a financial subsidiary.* The following are examples of how a member bank must value its purchase of or investment in securities issued by a financial subsidiary of the member bank. Each example involves a securities underwriter that becomes a financial subsidiary of the member bank after the transactions described below.

(i) *Initial valuation.* (A) *Direct acquisition by a member bank.* A member bank pays \$500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is \$500. The member bank initially must value the investment at \$500.

(B) *Contribution of a financial subsidiary to a member bank.* The parent

holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at \$500, and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The member bank initially must value the investment at the carrying value of the shares on the member bank's parent-only GAAP financial statements. Under GAAP, the member bank's initial carrying value of the shares would be \$500.

(ii) *Carrying value not adjusted for earnings and losses of the financial subsidiary.* A member bank and its parent holding company engage in the transaction described in paragraph (b)(3)(i)(B) of this section, and the member bank initially values the investment at \$500. In the following year, the securities underwriter earns \$25 in profit, which is added to its retained earnings. The member bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the member bank must continue to value the investment at \$500. If, however, the member bank contributes \$100 of additional capital to the securities underwriter, the member bank must value the aggregate investment at \$600.

(c) *Treatment of an affiliate's investments in, and extensions of credit to, a financial subsidiary of a member bank*—(1) *Investments.* Any purchase of, or investment in, the securities of a financial subsidiary of a member bank by an affiliate of the member bank is treated as a purchase of or investment in such securities by the member bank.

(2) *Extensions of credit that are treated as regulatory capital of the financial subsidiary.* Any extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank is treated as an extension of credit by the member bank to the financial subsidiary if the extension of credit is treated as capital of the financial subsidiary under any Federal or State law, regulation, or interpretation applicable to the subsidiary.

(3) *Other extensions of credit.* Any other extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank will be

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treated as an extension of credit by the member bank to the financial subsidiary, if the Board determines, by regulation or order, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or the Gramm-Leach-Bliley Act.

§ 223.33 What rules apply to derivative transactions?

(a) *Market terms requirement.* Derivative transactions between a member bank and its affiliates (other than depository institutions) are subject to the market terms requirement of § 223.51.

(b) *Policies and procedures.* A member bank must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its derivative transactions with affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising at any one time from the member bank's derivative transactions with each affiliate and all affiliates in the aggregate (through, among other things, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements); and

(2) Ensuring that the member bank's derivative transactions with affiliates comply with the market terms requirement of § 223.51.

(c) *Credit derivatives.* A credit derivative between a member bank and a nonaffiliate in which the member bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the member bank is a guarantee by a member bank on behalf of an affiliate for purposes of this regulation. Such derivatives would include:

(1) An agreement under which the member bank, in exchange for a fee, agrees to compensate the nonaffiliate for any default of the underlying obligation of the affiliate; and

(2) An agreement under which the member bank, in exchange for payments based on the total return of the underlying obligation of the affiliate, agrees to pay the nonaffiliate a spread over funding costs plus any deprecia-

tion in the value of the underlying obligation of the affiliate.

Subpart E—Exemptions from the Provisions of Section 23A

§ 223.41 What covered transactions are exempt from the quantitative limits and collateral requirements?

The following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12 or the collateral requirements of § 223.14. The transactions are, however, subject to the safety and soundness requirement of § 223.13 and the prohibition on the purchase of a low-quality asset of § 223.15.

(a) *Parent institution/subsidiary institution transactions.* Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.

(b) *Transactions between a member bank and a depository institution owned by the same holding company.* Transactions with a depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution.

(c) *Certain loan purchases from an affiliated depository institution.* Purchasing a loan on a nonrecourse basis from an affiliated depository institution.

(d) *Internal corporate reorganization transactions.* Purchasing assets from an affiliate (including in connection with a transfer of securities issued by an affiliate to a member bank described in paragraph (a) of § 223.31), if:

(1) The asset purchase is part of an internal corporate reorganization of a holding company and involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate;

(2) The member bank provides its appropriate Federal banking agency and the Board with written notice of the transaction before consummation, including a description of the primary business activities of the affiliate and an indication of the proposed date of the asset purchase;